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Financial Markets

Irving Trust

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Friday
(Noon)

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The level of a bond's yield--by itself--is not enough to recommend a bond purchase, as financial markets experts know. While everyone wants to buy bonds cheap (when yields are high) and sell them dear (when yields are low), arguments based on yields alone do not suffice. Too often, markets have taken an undervalued asset and undervalued it further. Frequently, the judgment that an asset is priced too cheap takes longer than anticipated to be borne out. Since many participants are involved for the short-term gains the market can provide, advice based on longer-term fundamentals often is eschewed. Nonetheless, bonds do look like they are underpriced. Let's see why.

As I have already said, a look at yields alone does not suffice. So let's go back to August, the time when the current 12% coupon long bond was born. Those times were scarier than these. The Fed was then in the process of watching M1 grow at a rate well above the top of its growth range. This had happened to the Fed's previous two targets, causing the Fed to scrap the second one and reestablish the new monitoring range: the very one that M1 was failing to fall within in early August. As the economy was clipping along quite nicely and the Fed had been consistently allowing a nudging up of the Fed funds rate, it made some sense for the markets to be worried about rates. Thus the auction of the new long bond in August produced a 12% coupon.

These times should not hold the same fears. Yet, the long-term markets are priced just as "fearful" as they were back in August. M1 is now <u>below</u> the bottom of that same range it had been above in August. While it's true that this Friday (Dec. 16) should bring a large increase in M1 (approx. $5.5 billion), M1 is $2.1 billion below the bottom of its growth cone, so (given that the bottom of the cone grows about $0.6 billion per week) such an increase would leave M1 $2.8 billion above the bottom --not a very worrisome situation, certainly not fearful.

Moreover, the Fed hardly seems as positioned to force rates up now as it did back in August. Granted, M1 is not the only thing that matters. Yet the Fed's actions this year are better understood by looking at <u>nothing else</u>: Trying to explain the Fed's actions over the course of this year by tracking other aggregates would have been more confusing than helpful. Yes, the Fed is looking at the economy--which has fooled it once already this year. But this does not argue for <u>higher</u> rates as much as it might argue for a continued firmness (a plateau). Besides, the market has already tightened so much, the Fed does not need to do more. Indeed, long-term rates are already so high the Fed might even prefer to see them fall somewhat before putting more pressure on overnight rates. Although the economy looks fine now, let's not forget that interest rates are very high relative to current inflation. Economic weakness has a nasty habit of showing up when least expected and without invitation. The Fed knows that the high rates of this year have been invitation enough.

Robert A. Brusca

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Market Yields

	12/16/83 (Noon)	Week Ago	Year Ago
Prime Lending Rate at Irving Trust Company	11.00%	11.00%	11.50%
Effective since	8/8/83		
Discount Rate at Federal Reserve Bank	8.50	8.50	8.50
Federal Funds	9.75	9.44	8.75
Repurchase Agreements	9.70	9.40	8.75
U.S. Treasury Issues			
Bills			
3 months	9.47	9.33	8.02
6 months	9.82	9.74	8.43
1 year	10.07	10.08	8.74
Coupons			
2 years	10.84	10.82	9.58
4 years	11.43	11.38	10.11
7 years	11.84	11.79	10.71
10 years	11.88	11.86	10.58
Long Bond	11.95	11.93	10.67
Negotiable Certificates of Deposit-Secondary Market			
1 month	10.05	9.55	8.70
3 months	10.00	9.65	8.70
6 months	10.10	9.95	8.85
1 year	10.80	10.45	9.25
Banker's Acceptances			
1 month	10.22	9.52	8.70
3 months	10.24	9.75	8.75
6 months	10.37	9.94	8.95
Eurodollar Deposits			
1 month	10.63	10.19	9.56
2 months	10.56	10.19	9.56
3 months	10.56	10.25	9.69
Commercial Paper - Prime Names			
Directly placed by:			
Finance Companies			
1 week	9.90	9.53	8.63
1 month	10.12	9.66	8.68
3 months	9.78	9.60	8.54
Bank Holding Companies			
1 month	9.45	9.19	7.40
Dealer Placed:			
3 months	10.24	9.73	8.41
New AA Corporate Utility Bond	13.20	13.20	12.40
Tax Exempt			
6 month Project Notes	5.60	5.55	4.70
1 year AAA Bond	5.80	6.00	5.00
5 year AAA Bond	7.45	7.25	6.70
20 year AAA Bond	9.80	9.25	9.20

This information represents prevailing market yields.
It should not be construed as an offering.
All yields are on the offered side of the market.

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